

Final Exam Study Guide  
July 29, 2005

This study guide contains much of the material that will be on the final exam. There may be other topics or questions included that are not in this guide, but that were covered in class or in the text or in the reader. I will not ask you for details of readings we did not cover in class, but you should try to get the basic elements out of every reading. More important than details is a comprehensive understanding of the basic theoretical issues and tools. Make sure you know them and can manipulate them before working on the minor issues.

**International finance**

1. Someone mentioned to you that the U.S. trade deficit with China is the single most important economic problem confronting the United States today. Explain what this statement could mean.
2. What was the debate in the mid-1980s over the meaning of the U.S. trade deficit? Use the savings=investment identity to clarify the issues.
3. Define the balance of payments.
4. Explain the concept of purchasing power parity. What is PPP used for? What is the big Mac index?
5. What determines exchange rates in a floating system? Concentrate on the interest parity condition.
6. Explain the Dornbusch overshooting model. Why was it an important model in the mid-1970s? (What public policy issue did it address?)

**International trade**

A Korean acquaintance of yours explains to you that Korea needed to have high import protection against both rice and steel because Japan had a productivity advantage in both and could produce both more cheaply than the Koreans could. Use your recently acquired knowledge of international trade theory to argue that your acquaintance has not offered a convincing justification for the import protection.

1. Start by analyzing the Ricardian model in a situation where Korea has an absolute disadvantage in both steel and rice compared with Japan, but Korea is relatively less disadvantaged in rice. Setup the model, using either symbols or numbers of your own choosing to represent productivity. (4 points)
2. Draw production possibility frontiers for the two countries, where every point is clearly labeled. (4 points)
3. Derive what the pre-trade price ratios will be in both countries. Explain the assumption you used to derive the ratio. (4 points)
4. Interpret/explain, in clear English, what these pre-trade price ratios mean, and what they tell you about the pattern of trade when the two countries open up for trade. (4 points)
5. Demonstrate/prove that there are gains from trade. Assume that the post-trade price ratio falls between the two pre-trade price ratios. Be sure to clearly explain in words what you demonstrate on the graphs. (4 points)
6. Continue your argument with your acquaintance by showing him/her the costs of protection. Draw a simple supply and demand graph for the steel industry, and show what the price, import volume, and welfare effects are

when it receives protection from a tariff. Assume that the world price remains constant. (8 points)

7. Use the sector specific model to illustrate the income distribution effects of trade- be sure to analyze the income distribution effects for all three factors of production.

8 . Now list and briefly explain three reasonably 'sophisticated' and convincing ways that a tariff on an industry might be justified. (Raising the income of the factors of production in that industry is not a convincing argument, so don't list it!). Might they apply to the rice or steel industries? Why or why not? (12 points)

9. Finally, explain to your friend how the Boeing-Airbus case nicely illustrates one of the possible 'sophisticated' arguments against free trade. What are some of the problems with the argument? (10 points)